Accounting Rate Reform and Costing Methodologies

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Seminar on Costs and Tariffs in Africa
Nairobi, 6-7 March 2000

Note: The views expressed in this presentation are those of the author and do not necessarily reflect the opinions of the ITU or its membership.

Some DATA(1998)

Intern'l Telephone revenue : 56 billion US $

Net Settlement payment to developing countries amount to around : 5 billion US$

Int'l Infrastructure costs reduction: < 20 %

Annual average A/R reduction: < 12 %

Annual average User Price reduction: 5 %

Actual Situation

- **New Remuneration system (adopted)**
  - ⇨ **Termination charge system**
  - ⇨ **Settlement rate system**
  - ⇨ **Special arrangement**
- **Difficulty to quickly implement those systems**
  - ⇨ **Condition is to reach cost-oriented rate, but**
  - ⇨ **No cost data or model for some administrations**
- **Transitional arrangements (review at WTSA)**
  - ⇨ **To facilitate staged reduction to cost based rate**
  - ⇨ **to avoid sudden fall of revenue (smooth transition)**

Recommendation D.140

- **Following 5 principles should be apply**
  - ⇨ **Cost oriented**
  - ⇨ **Non discrimination**
  - ⇨ **may be implemented on a scheduled basis**
  - ⇨ **periodical negotiation**
  - ⇨ **information should be made available**
- **Recommendation has 4 annexes**
  - ⇨ **A. Guideline for cost elements**
  - ⇨ **B. Information relating to accounting rates**
  - ⇨ **C. Guideline for bilateral negotiation**
  - ⇨ **D. Transitional arrangements (end 1998)**

Annex E to Recommendation D.140 “indicative target rates” by Teledensity (T) Band, in SDR (and US cents) per minute.

T<1	1<T>5	5<T<10	10<T<20	20<T<35	35<T<50	T>50
0.327 SDR	**0.251 SDR**	**0.210 SDR**	**0.162 SDR**	**0.118 SDR**	**0.088 SDR**	**0.043 SDR**
43.7¢ (end 2001)	33.5¢ (end 2001)	28.0¢ (end 2001)	21.6¢ (end 2001)	15.8¢ end 2001)	11.8¢ (end 2001)	5.7¢ (end 2001)
Low income FCC : 23 ¢ (January 2002/2003)		*Lower middle* FCC : 19 ¢ (January 2001)		*Upper middle* 19 ¢(J.2000)	*High income* FCC : 15 ¢ (January 1999)	

Note: The correspondence between teledensity band and income group shown in the bottom row is intended to be approximate, not precise. Source: ITU-T SG3 Report. 1 SDR = US$1.39.

Final Report Recommendations on target rates for transit shares, in SDR (and US$) per minute

On route where an origin Administration lacks choice* among transit routes and service providers, it is recommended that transit Administration move towards the indicative target rate (upper limit) of 0.05 SDRs (0.0675 US $) per minute.

* Only has access to three or less independent and comparable transit providers

Bad news

- In December, SG3 did not approve D.140
  - ⇨ USA opposed
  - ⇨ 66 countries (74% of US outband traffic) accepted already FCC Benchmark Order
  - ⇨ Others are waiting to see what ITU does
- Remaining options are:
  - ⇨ Accept FCC Benchmark Order
  - ⇨ Revised D.140 Annex E again (probably no consensus) or develop principles on transit rates
  - ⇨ Introduce termination charge
- Transitional arrangements (Annex E) can be discussed in the WTSA

Good news

- **Implementation of Asymmetric rates**
  - ⇨ **Except North America, operators accept more and more asymmetric arrangements (UK-Russia)**
- **Implementation of volume based rates**
  - ⇨ **Many operators accept different rates according to the volume of traffic**
- **With the reduction of accounting rate, there is less imbalance of traffic**
  - ⇨ ***Hong Kong China – USA 1 : 9 in 1997***
    1 : 1.2 in 1999
    (expected)

Mini Case Study for KUWAIT

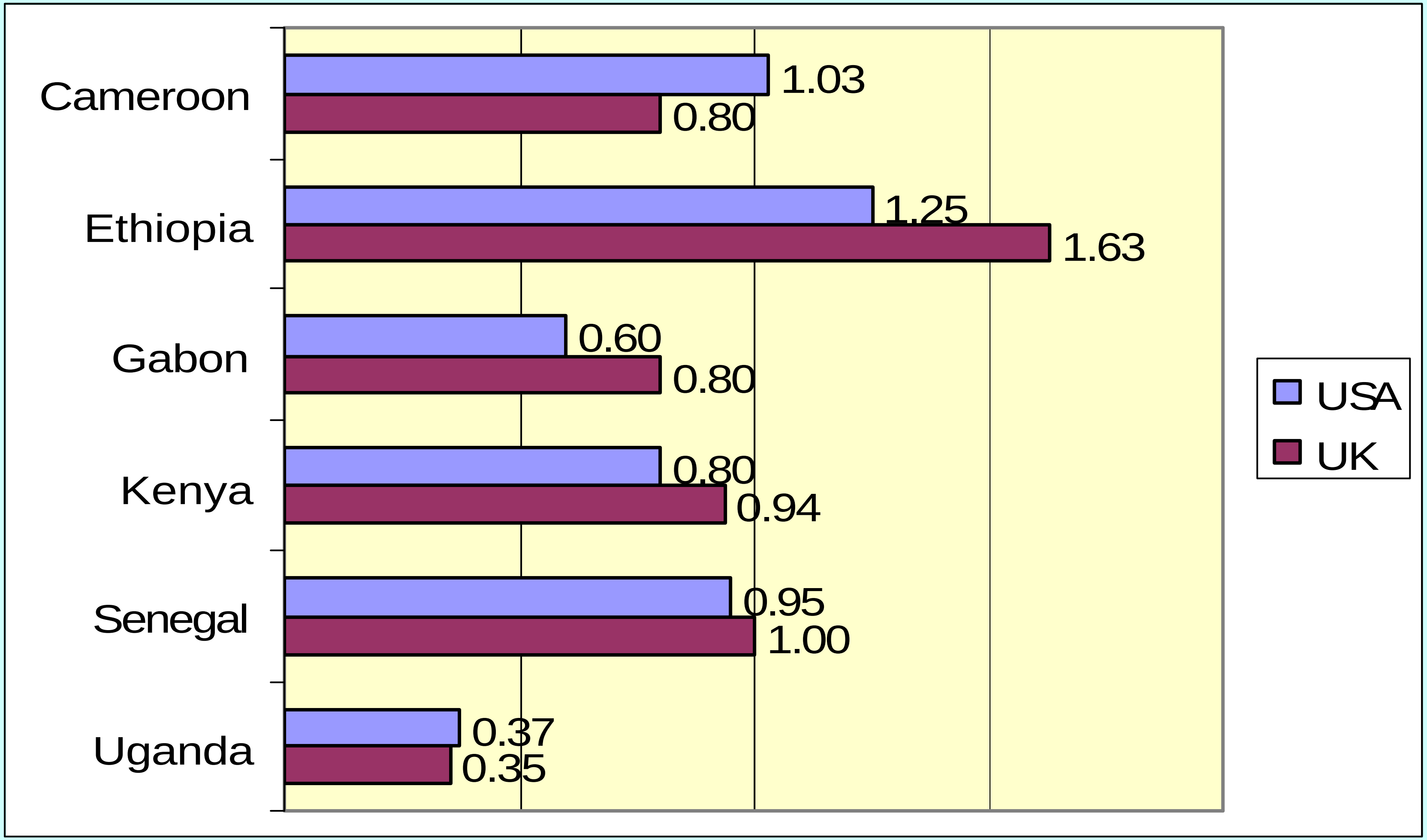
- **Kuwait reduced accounting rates and charge**

year	Accounting rate to US	Collection charge to US
1998	1.59$	1.65$
1999	0.30$	0.60$

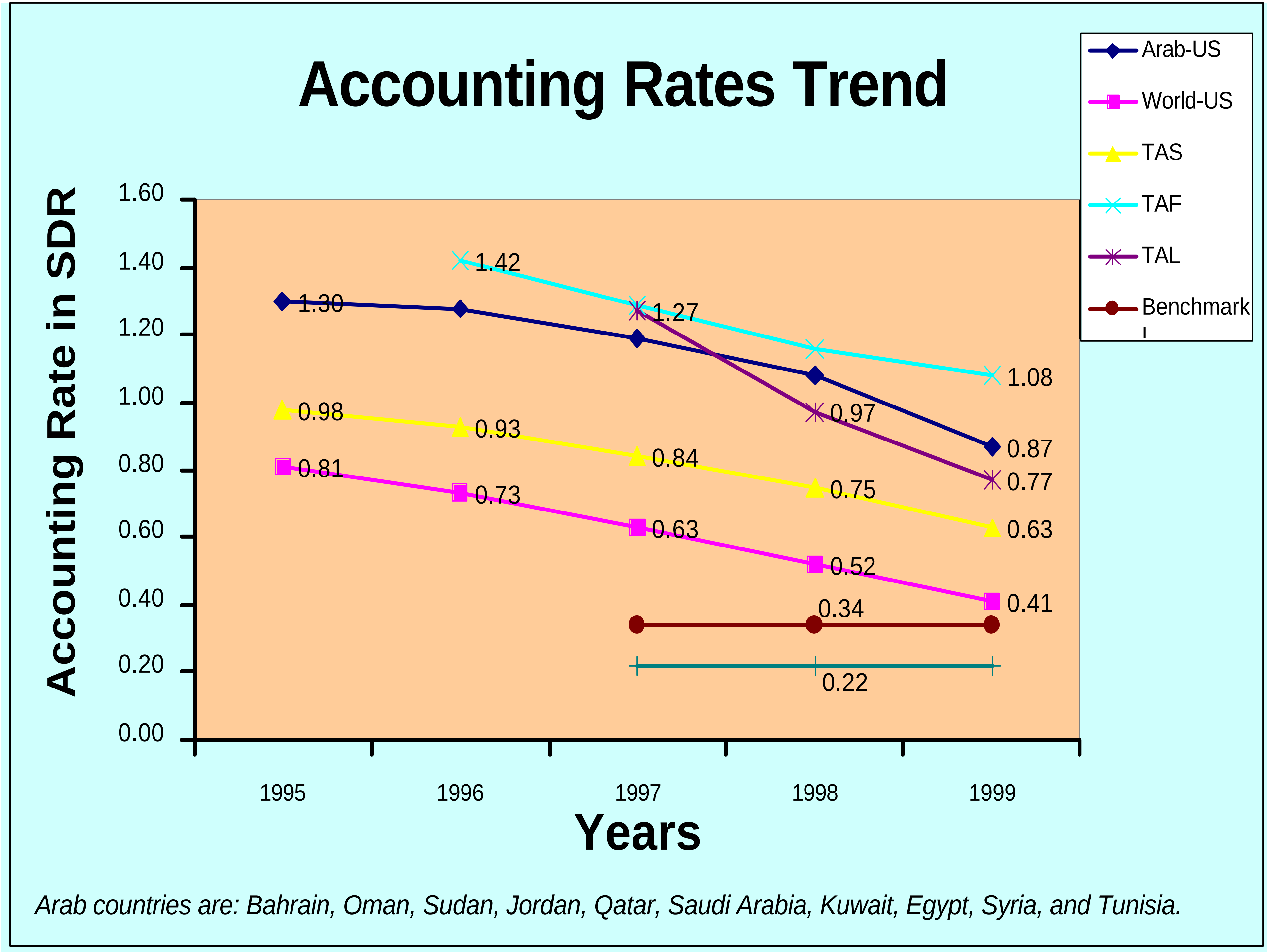
- **Expected revenue from Kuwait – US relation**

year	If 1 : 5.34	If 1 : 1.2
1998	41.88 Million $	41.88 Million $
1999	13.59 Million $	26.11 Million $

Current settlement rates from US and UK to selected African countries (SDR)



Source: ITU, adapted from FCC, US date is November 1st, 1999, UK data is January 1st 1999


Accounting Rates Trend
Arab-US
World-US
TAS
TAF
TAL
Benchmark
Accounting Rate in SDR
1.60
1.40
1.20
1.00
0.80
0.60
0.40
0.20
0.00
1.42
1.30
1.27
1.08
0.97
0.87
0.77
0.98
0.93
0.84
0.75
0.63
0.81
0.73
0.63
0.52
0.41
0.34
0.22
1995
1996
1997
1998
1999
Years
Arab countries are: Bahrain, Oman, Sudan, Jordan, Qatar, Saudi Arabia, Kuwait, Egypt, Syria, and Tunisia.

Development of Cost Model in SG3

- **Telecommunication Service = Traded Service**
  - ⇨ **Need to know the cost of its product**
- **WTPF 98 invited ITU Members :**
  - ⇨ **To introduce a cost-accounting mechanism in order to establish the real costs of providing services**
- **Plenipotentiary Conference (98) urged ITU-T SG3**
  - ⇨ **To expedite its work on developing appropriate costing methodologies services**
- **SG3 decided in December 1998**
  - ⇨ **To create a Rapporteur Group**

Results of Rapporteur Group

- **A common ITU cost model is illusive**
  - ⇨ **Each should develop its own cost model**
  - ⇨ **Regional cost model can be used as reference**
- **Objectives for developing cost model**
  - ⇨ **Information on costs that allow pricing on a competitive market**
  - ⇨ **Cost information for the formation of price that assure recovery of all relevant costs**
- **Different costing methodologies compared**
  - ⇨ **Not much difference if correctly applied**
- **Establishment of general principles and rules**

Cost Model

OBJECTIVES

BUSINESS DECISION SUPPORT

- Pricing and Product Planning
- Investment evaluation
- Economics of direct/transit routing

FINANCIAL CONTROL

- Monitor actual performance and compare with plan and past trends
- Cost control
- Identify Cross Subsidy

REGULATORY COMPLIANCE

- Set D.140 as globally acceptable standard
- Rationalize tariff charges
- Derive TAR, USO

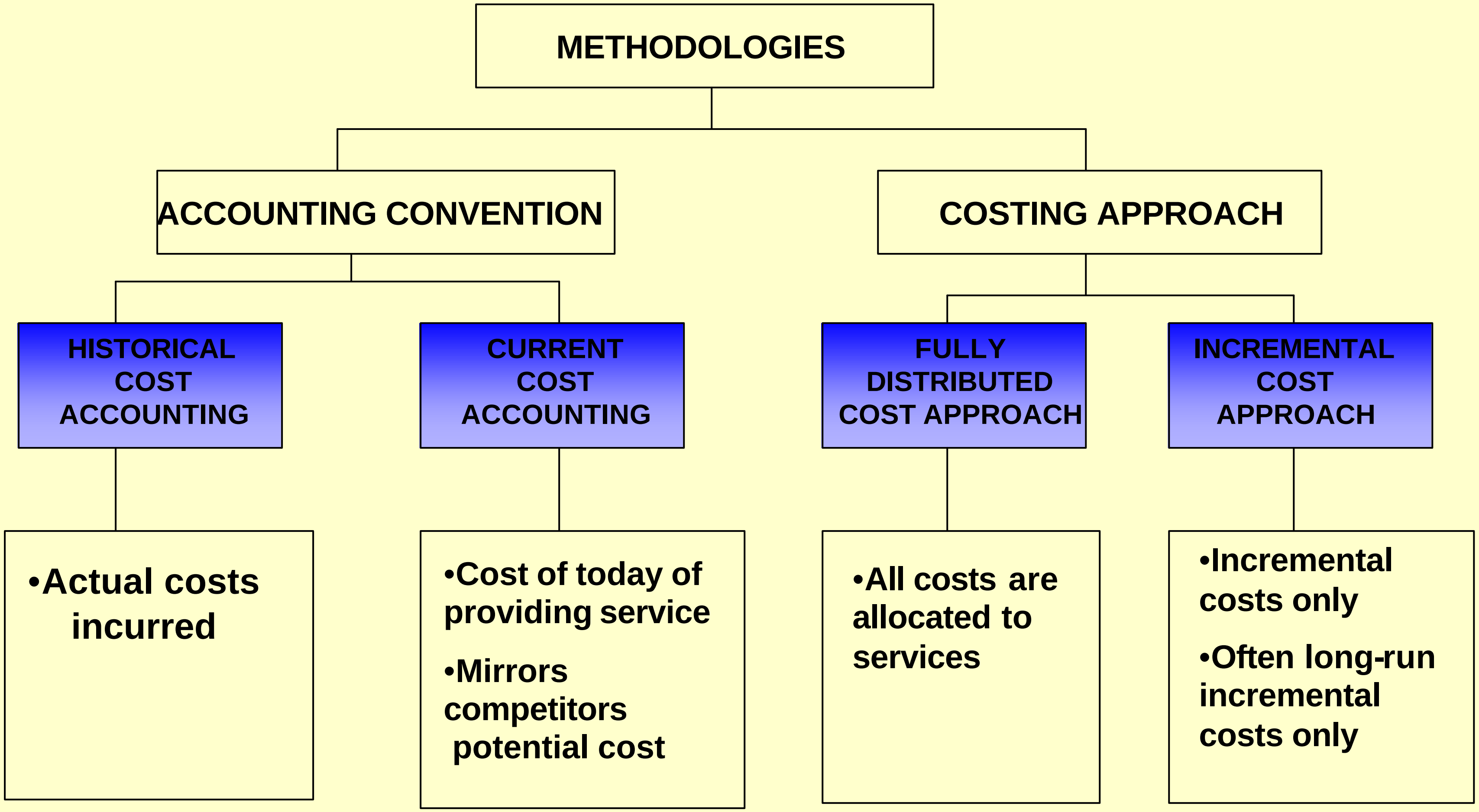
MARKETING

- Minimize opportunity for arbitrage
- Generate more revenue by increased traffic

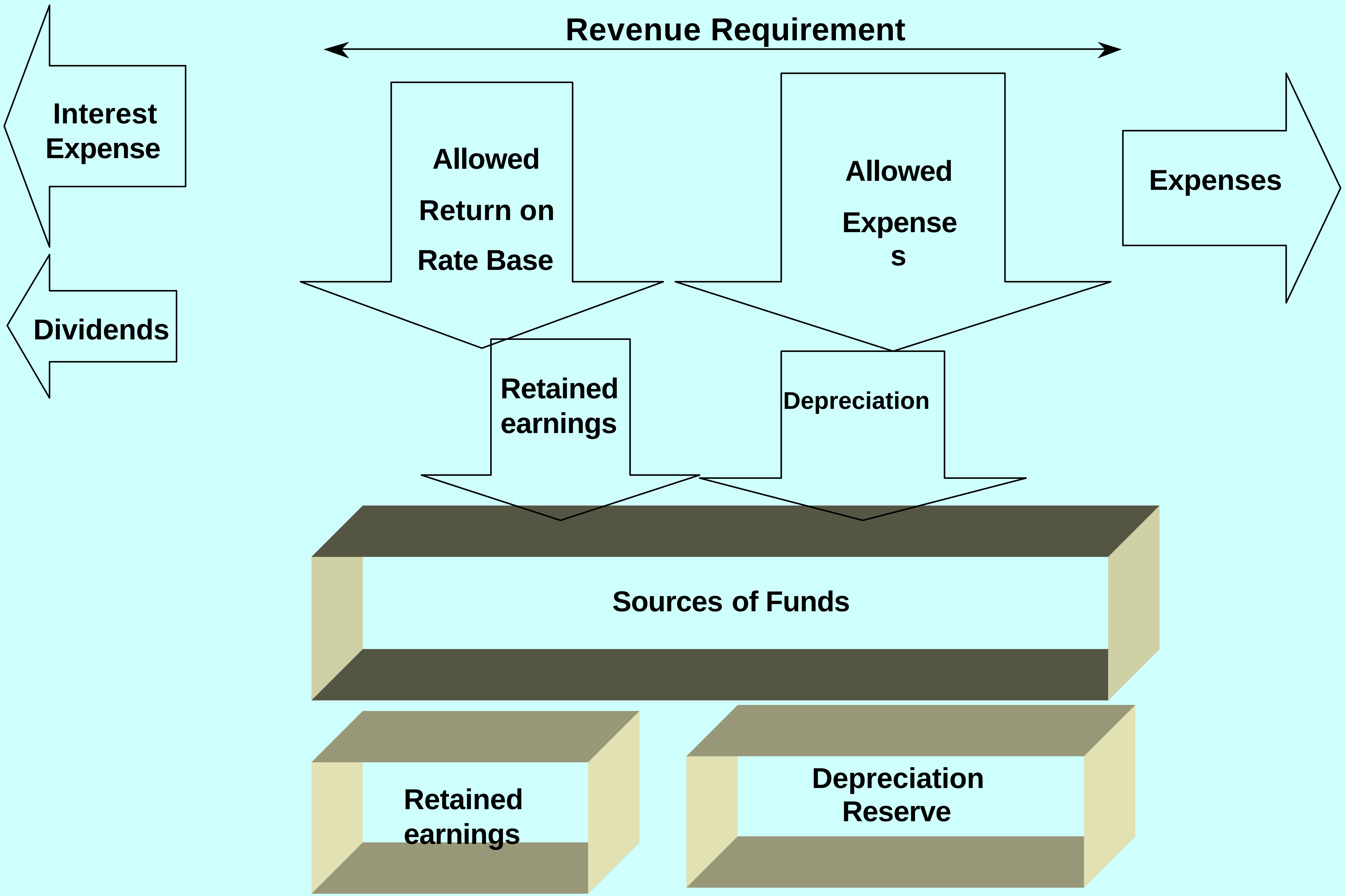
TECHNOLOGY

- Enhancement towards global technology
- Long term cost/benefit of technology and options
- Impact of technology on global relations

Costing Methodologies



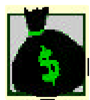
FDC



Revenue Requirement
Interest Expense
Dividends
Allowed Return on Rate Base
Allowed Expense s
Expenses
Retained earnings
Depreciation
Sources of Funds
Retained earnings
Depreciation Reserve

Problems of FDC

	A	B	C	D		A	B	C	D
Revenue	60	48	59	18		60	0	59	18
Incremental Cost	40	40	40	10		60	0	40	10
Fixed common cost	11	9	15	5	delete B ?	0	0	15	5
Fixed common cost	3	3	3	1		5	0	4	1
FDC	54	52	58	16		65	0	59	64
Segment Profit	6	-4	1	2	-$8	-5	0	0	2



Corporate Profit: 5

Cross subsidy from A,C,D to B

-3

Decision Making by Incremental Costing

	A	B	C	D		A	B	C	D
Revenue	60	48	59	18		60	48	59	18
Incremental Cost	40	40	40	10		40	40	40	10
Fixed common cost	11	9	15	5	All services are retained	20	8	19	8
Fixed common cost	3	3	3	1		20		20	
FDC	54	52	58	16	Both LOB is retained	8		7	
Segment Profit	6	-4	1	2		10			
Corporate Profit	5				$0	5			

No much difference if…

- **Current cost accounting is used**
  - ⇨ **FDC=Historical Cost is no more relevant**
- **Cost of efficient services provision is used**
  - ⇨ **this should be the aim of all operators**
  - ⇨ **spare capacity (legitimate if transparency)**
  - ⇨ **Disagreement on time horizon to achieve this**
- **Principle of cost causality is applied (ABC)**
  - ⇨ **Common cost must be attributed to the service on the basis of the causality principle**
  - ⇨ **However an exhaustive application of an ABC approach may be very costly**
- **Need for cost recovery realised appropriately**
  - ⇨ **IC approach should contain a markup**

Agreed General principles

- **Principle of transparency** : ***The open availability of information used in the cost deviation process in order to allow comprehension of the final rate from the vantage point of an external analyst***
- **Principle of practicability** : ***The ability to implement a costing methodology with reasonable demands being placed on data availability and data processing in order to keep the costing exercise economical, yet still useful***
- **Principle of cost causality** : ***The demonstration of clear cause-and-effect relationship between service delivery on the one hand and the network element and other resources used to provide it on the other hand, taking into account the relevant underlying cost determinants (cost drivers)***
- **Principle of reasonable contribution to common costs** : ***Costing methodologies should provide for a reasonable contribution to common costs***
- **Principle of efficiency** : ***The provision of a forecast of cost reductions that result from a more efficient combination of resources***

Cost model resolves everything?

- **Accounting rate is established by negotiation**
  - ⇨ **Rates need to be agreed upon in negotiation**
  - ⇨ **Market-determined prices put pressure upon negotiation**
- **Need to back up its claim for a charge**
  - ⇨ **By showing the price of a comparable competitively offered service**
  - ⇨ **Or for monopoly by providing relevant cost data**
- **"Costs" = tools for negotiation, "costs" do not fix automatically the level of accounting rates**

African Operators' actions

- **Develop quickly its own cost model**
- **Rebalance tariff**
- **Recognise that costs are relatively low**
  - ⇨ **costs in developing countries are high**
  - ⇨ **but not ten times**
- **Need to implement quickly transitional arrangements to the cost**
  - ⇨ **understand the concept and negotiate in line**
  - ⇨ **but request continued viability (dependence on int'l revenue, assymetrical arrangement etc.)**
- **Request reduction of transit share**